

ANALYSIS OF AMENDED BILL

Author: Briggs Analyst: Garnier Bill Number: AB 867
Related Bills: SB 671 (1993) Telephone: 845-5322 Amended Date: 05/11/99
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: S Corporation Taxation Elimination of 1.5% Tax Rate

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

☒ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED 2/25/99 STILL APPLIES.

OTHER - See comments below.

SUMMARY OF BILL

This bill would eliminate the 1.5% measured tax on S corporations while maintaining all other taxes currently assessed on S corporations, including the minimum franchise tax.

Because of the elimination of the measured tax, other S corporation provisions in California law would no longer be necessary. This bill would remove these provisions and conform to the federal treatment of the use of C corporation tax credits carried over into S corporation tax years. This bill also would require all corporations (other than grandfathered California-only C corporations) that are S corporations for federal purposes to be S corporations for California purposes. This bill also would restructure the requirements for nonresident shareholders of an S corporation regarding consents and tax returns to generally follow the rules applicable to a nonresident member of a limited liability company.

SUMMARY OF AMENDMENT

The bill as introduced removed all taxes, including the minimum franchise tax, on S corporations. The amendment provides that only the 1.5% measured tax be eliminated and also provides for the aforementioned changes under the summary.

EFFECTIVE DATE

As a tax levy, this bill would be effective and operative for income years beginning on or after January 1, 1999.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald Goldberg

5/14/1999

LEGISLATIVE HISTORY

SB 671 (Alquist) (Stats. 1993, Ch. 881) reduced the measured tax from 2.5% to 1.5%, for income years beginning on or after January 1, 1994.

SPECIFIC FINDINGS

The background information contained in the "Specific Findings" of the bill analysis, dated February 25, 1999, still applies.

Federal and California laws provide that a corporation can terminate its S corporation election by either revocation (elective) or by ceasing to qualify as a small business corporation (mandatory). If a corporation terminates its "S" election, it may not elect to be an S corporation again for five income years.

Federal law does not have a measured tax on S corporations. **Federal and California laws** do tax at the C corporation tax rate "built in gains" (BIG) recognized by an S corporation.

Under **federal law**, a C corporation, which has tax credit carryovers and which elects to be an S corporation, may carry the C corporation tax credits over to "S" tax years to reduce BIG taxes.

California law provides that a C corporation tax credit carried over to an "S" income year shall be reduced by two-thirds and may be used to reduce the 1.5% measured tax assessed on the S corporation. California law does not allow an S corporation to reduce BIG taxes by any credit carried over from a "C" income year.

California law provides that a corporation that is an S corporation for federal purposes is an S corporation for state purposes. Because of the measured tax of 1.5% (originally 2.5%) that is assessed on the net income of an S corporation, a corporation with a valid federal "S" election may elect, within the first 2½ months of the income year, to be a C corporation for state purposes.

California law requires California S corporations with nonresident shareholder(s) to obtain and attach to their tax return a signed statement of consent from each nonresident shareholder. The consent must state that the nonresident shareholder is subject to the tax imposed by the Revenue and Taxation Code on the nonresident's pro rata share of the S corporation's income attributable to California sources. If the S corporation does not fulfill this requirement, the Franchise Tax Board may retroactively revoke the corporation's "S" election.

This bill would eliminate the S corporation measured tax rate of 1.5%. S corporations would still be liable for the minimum franchise tax (currently \$800 in most circumstances). Additionally, as under federal law, S corporations would still be assessed the BIG taxes, last-in, first-out inventory recapture taxes, and excess passive income taxes.

This bill also would repeal California's treatment of C corporation tax credits carried over to S corporation tax years and conform to the federal rules allowing C corporation carried over credits to be used to offset BIG taxes.

This bill would require all corporations that are S corporations for federal purposes to be S corporations for California purposes, effective for income years beginning on or after January 1, 1999. Corporations would no longer be able to elect to be a C corporation for California purposes only. However, this rule would not apply to corporations which, as of March 15, 1999, met all of the following requirements:

- Were doing business in this state.
- Had in effect a valid S corporation election for federal income tax purposes.
- Had in effect a valid C corporation election for California income tax purposes.

This bill would allow a California C corporation that meets the above requirements to elect to be a California S corporation. For income years beginning on or after January 1, 1999, and before January 1, 2000, the corporation must make the election before the due date of its return (without regard to extensions). For income years beginning on or after January 1, 2000, the election must be made within 2½ months after the start of the income year. The election may be made even if the corporation terminated its California "S" election within the prior five years.

This bill would restructure the reporting requirements of an S corporation with nonresident shareholders. This bill would require an S corporation to attach to its original, timely filed return an agreement for each nonresident shareholder. The agreement must state that the nonresident shareholder agrees to file a return and timely pay all taxes on the nonresident shareholder's pro rata share of the S corporation income and be subject to the taxes, related interest and penalties imposed by this state on the income of the S corporation attributable to this state. In the absence of this consent to jurisdiction agreement, the S corporation would be required to pay the tax due on the nonresident shareholder's distributive share of the S corporation's income at the highest California personal income tax rate. The S corporation could recover any taxes paid on behalf of the nonresident shareholder from that shareholder. If the nonresident shareholder files a timely return reporting the pro rata share of the S corporation income and pays the tax, the S corporation would not be liable for the failure to pay tax penalty and interest on the nonresident's tax.

This bill would repeal the provision permitting the FTB to retroactively revoke a corporation's "S" election for failure to file nonresident consent forms.

Finally, **this bill** would make numerous technical changes to facilitate the repeal of the measured tax and also would repeal certain transitional rules enacted in the late 1980s when California first conformed to the federal treatment of S corporations that are now unnecessary.

FISCAL IMPACT

Departmental Costs

This would not significantly increase the department's costs.

Tax Revenue Estimate

Revenue losses under the Bank & Corporation Tax Law from eliminating the 1.5% measured tax on S corporations, but retaining the \$800 minimum franchise tax and miscellaneous taxes, are estimated as follows:

Effective January 1, 1999 Assumed Enactment After June 30, 1999 (in millions)			
1999-0	2000-1	2001-2	2002-3
(\$355)	(\$270)	(\$285)	(\$300)

Tax Revenue Discussion

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

The above estimates are based on current state data and reflect eliminating the 1.5% tax, but retaining the \$800 minimum franchise tax, and miscellaneous taxes currently imposed on "S" corporations. The number of S corporations doing business in California is projected to be approximately 125,400 for the 1999 income year.

Revenue losses and gains for the remaining changes would not have a significant cumulative net impact on the above estimates. Based on departmental and federal data, only 2,000 corporations with valid "S" elections under federal law have elected to be C corporations under California law (representing less than 2% of all existing S corporations).

The amendment differs from the original version dated February 25, 1999, by removing the provision that would have eliminated all taxes assessed on S corporations, including the minimum franchise tax. The elimination of the minimum franchise tax accounted for approximately \$100 million of the revenue loss as the bill was original introduced.

The revenue estimate for SB 671 in 1993, which reduced the S corporation measured tax rate from 2.5% to 1.5%, was approximately \$75 million loss per fiscal year. Because of California's economic condition in 1993, S corporations' actual and projected profitability was significantly lower than actual and projected profitability of S corporations today.

BOARD POSITION

Pending.